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Energy-as-a-Service Opportunities for Health Systems

Energy as a Service (Eaas) has long been part of the facility management toolkit for health systems. Whether it's a simple third-party lighting upgrade or more sophisticated remote monitoring of energy usage, health systems are actively adopting new technologies to optimize energy performance. These advancements not only improve operational efficiency but also support broader sustainability goals and cost-saving initiatives, making EaaS a strategic priority for many organizations.

The Inflation Reduction Act of 2022 has further intensified interest in EaaS by expanding renewable energy tax credits to 501(c)(3) organizations such as not-for-profit health systems and higher education institutions. As a result, health systems are now being approached by energy infrastructure providers and project developers with long-term EaaS proposals. These partnerships can range from managing energy assets for a single site to overseeing those for the full system. Many providers also offer capital funding as part of these agreements, helping health systems finance critical infrastructure improvements without straining their own resources.

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What is EaaS?

Under a typical EaaS partnership structure, the partner will make an upfront payment to the health system client (an advance lease payment) in exchange for the right to jointly use, operate, maintain, and renew the energy infrastructure over a defined time period. Through this arrangement the health system (the lessor) maintains ownership of the assets but transfers the right to operate to the partner (the lessee). The health system can apply this payment towards infrastructure projects, deferred capital needs, and energy optimization initiatives. (Note that this advance payment is one of the options to finance the new assets.) The EaaS partner guarantees a certain percentage of annual energy consumption savings, which help to offset the cost of the monthly operating agreement that the health system pays for energy-related services.

Why consider an EaaS partnership?

An EaaS partnership can offer several benefits to a health system. Depending on the size and current status of its energy infrastructure, a health system can use an EaaS partnership to:

- Provide the health system access to the partner's energy operational expertise and innovations, while enabling it to focus on its core healthcare mission.
- Mitigate performance risk by having the EaaS partner assume operational management or oversight.
- Support the health system in its efforts to achieve carbon footprint reduction commitments.
- Assist the health system in addressing budgetary challenges in funding energy-related improvements or replacements.
- Obtain favorable accounting treatment and credit rating views in certain circumstances.
- Grant access to third-party capital providers apart from MTI indebtedness.
- Potentially improve balance sheet liquidity by increasing the advance lease payment.

Capital considerations

Hospitals typically employ talented engineers and facilities managers who are well-versed in identifying potential efficiencies and savings within their energy infrastructure.

However, capital budgets are often constrained, and energy assets tend to be lower on the priority list when compared to both routine capital repairs and strategic growth initiatives. EaaS offers a solution by combining improved operational efficiencies with a financing model that treats the transaction as a lease whereby the hospital has the leased assets and, in lieu of debt, an operating expense.

The first step in pursuing EaaS is evaluating the cost/benefit of improving the energy infrastructure. The next step is determining how to capitalize the investment. While traditional financing options like equity or debt (taxable or tax-exempt) can be utilized, EaaS vendors offer the advanced lease payment as a capital source. Although this method may be slightly more expensive than direct funding, it provides certain advantages under the lease structure that can be appealing to health systems.

Accounting treatment considerations

An EaaS partnership has certain accounting treatment considerations:

- The agreement with the EaaS partner can be treated as a lease under ASC 842.
- The advance lease payment is initially accounted for as pre-paid rent, recognized as revenue that is amortized straight-line over the term of the agreement. Energy assets remain on the health system's books and continue to depreciate according to the normal depreciation policy.
- The monthly expenses that the health system pays to the EaaS partner under an operating agreement are recognized as an operating expense, even though debt service payments are embedded (passed through) in those expenses.
- On the balance sheet, the EaaS partnership funding structure often can be recognized as an off-balance-sheet liability.
    - A key component of this treatment is whether the operator is able to off-load a portion of the energy capacity.

While EaaS transactions can offer significant benefits to both sides of the partnership, they are inherently complex. It is imperative to understand the various funding and savings components involved.

- The advance lease payment is counted as a new revenue stream on the income statement; as noted earlier, guaranteed annual utilities savings under the EaaS partnership agreement also offset operating expenses associated with the operating agreement.

Credit rating agencies tend to take a favorable view of EaaS partnership structures; dependent on rating agencies and partnership structures, debt rating related to an EaaS partnership can be either on parity with or one notch lower than the health system's ratings.

Other potential EaaS partnership benefits

Health systems may find significant value in an EaaS partnership, particularly through the transfer of risk associated with the covered energy assets. The level of savings may vary depending on the types of retrofits involved; well-established solutions like LED retrofits may deliver quicker returns compared to newer technologies such as renewable energy. Risk transfers can include:

- **Operation and maintenance risk transfer**: The risk and costs associated with repairing, testing, operating, and maintaining the covered energy assets over the entire term of the partnership are immediately transferred to the EaaS partner.
- **Energy performance risk transfer**: Any risk of shortfall in energy performance is transferred to the EaaS partner for the entire partnership term.
- **Capital renewal risk transfer**: The obligation to renew or replace any covered energy assets that fail prior to their industry-rated useful life is transferred to the EaaS partner over the entire partnership term.

Additionally, EaaS partnerships offer opportunities for staff enhancement. Working with an EaaS partner can bring valuable insights from successful programs at other facilities, providing additional energy expertise and allowing the health system's internal engineering team to focus on other priorities. Health systems may also negotiate a personnel risk transfer, in which the EaaS partner assumes the risk of hiring, training, and retaining plant personnel by means of a labor services agreement.

Valuation, transaction structure, and counterparty risk

While EaaS transactions can offer significant benefits to both sides of the partnership, they are inherently complex. It is imperative to understand the various funding and savings components involved, as proper valuations for each component will ensure the healthcare provider is both appropriately compensated and adequately protected. Since healthcare providers have multiple funding channels available for capital needs, evaluating the trade-offs between EaaS and other funding alternatives is a key part of the decision-making process. Additionally, in-depth knowledge of EaaS counterparties and their value proposition is essential, especially when core assets are involved in the transaction.

Health systems with substantial energy infrastructure may derive significant value from an EaaS partnership. As these partnerships are being actively marketed, knowing what your health system wants from the partnership (see sidebar) will help you identify the right structure for a successful partnership that aligns with your objectives.

Key Questions to Define Your Organization's Point of View on EaaS Partnerships

If your health system is considering an EaaS partnership, some key questions that will help define your goals and objectives include:

- What is your organization's perspective on its current and future capital and operating expenses for its energy infrastructure?
  - Is the energy infrastructure a core component of your organization's business model?
  - How well do you manage expenses and optimize investment in the energy infrastructure?
  - How much of the energy infrastructure would your organization consider outsourcing to an EaaS partner?
  - Which facilities and energy assets would you include in the assessment?
- Is your organization seeking to raise additional funds over and above its capital expenditure requirements?
  - Does your organization want to maximize operating expense reductions or improve liquidity through increased advance lease payments?
- How concerned is your organization about the potential accounting implications and credit impact?
- What financial responsibilities is your organization prepared to assume?
- What does your organization want in its relationship with an EaaS partner?

To explore how an EaaS partnership could transform your energy infrastructure, enhance operational efficiency, and unlock capital, please contact Terry Shirey (tshirey@kaufmanhall.com) or Michael Tym (mtym@kaufmanhall.com).